SUPREME COURT, U.S.
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No. 96-842

In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES HERMAN O'HAGAN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTIONS PRESENTED

1. Whether respondent's trading in securities on material, nonpublic information that he misappropriated in breach of his fiduciary duties violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

2. Whether the Securities and Exchange Commission validly exercised its rulemaking authority under Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(e), in promulgating Rule 14e-3(a), 17 C.F.R. 240.14e-3(a), an insider trading rule relating to tender offers.

3. Whether respondent's trading in securities on material, nonpublic information that he misappropriated in breach of his fiduciary duties violated the mail fraud statute, 18 U.S.C. 1341, even if his conduct did not violate the securities laws.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-39a) is reported at 92 F.3d 612. The order of the district court denying the motion to dismiss the indictment (Pet. App. 73a-74a) and the report and recommendation of the magistrate judge (Pet. App. 40a-72a) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 2, 1996. A petition for rehearing was denied on November 13, 1996. Pet. App. 75a. The petition for a writ of certiorari was filed on November 26, 1996, and was granted on January 17, 1997 (J.A. 215). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The texts of 18 U.S.C. 1341, 15 U.S.C. 78j(b), 15 U.S.C. 78n(e), 15 U.S.C. 78t-1(a), 17 C.F.R. 240.10b-5, 17 C.F.R. 240.14e-3(a), and Section 2 of the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, 15 U.S.C. 78u-1 note, are reprinted in an appendix to this brief.

STATEMENT

Following a jury trial in the United States District Court for the District of Minnesota, respondent was convicted on 20 counts of mail fraud, in violation of 18 U.S.C. 1341; 17 counts of securities fraud, in violation of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j(b), and Securities and Exchange Commission (SEC) Rule 10b-5, 17 C.F.R. 240.10b-5; 17 counts of fraudulent trading in connection with a tender offer, in violation of Section 14(e) of the Exchange Act, 15 U.S.C. 78n(e), and SEC Rule 14e-3(a), 17 C.F.R. 240.14e-3(a); one count of engaging in a monetary transaction in property derived from an unlawful activity, in violation of 18 U.S.C. 1957; and two counts of money laundering, in violation of 18 U.S.C. 1956(a)(1)(B)(i). He was sentenced to 41 months' imprisonment, to be followed by three years of supervised release, and was fined $150,000. The court of appeals reversed all the convictions. Pet. App. 1a-39a.

1. Respondent was a senior litigation partner in the law firm of Dorsey & Whitney (Dorsey), located in Minneapolis, Minnesota. He was also a sophisticated securities trader and had accounts at several brokerage firms. J.A. 62-63, 131, 138-139, 152; VIII Tr. 53.

In October 1986, respondent's client, Northrup King, transferred $1 million to the law firm's trust account as part of the preliminary settlement of a securities lawsuit.

IIa Tr. 67-74; III Tr. 14-17, 24-26. Although the settlement funds were to remain in a trust account until they were disbursed to the plaintiffs, respondent withdrew the entire $1 million through transfers to his personal bank accounts. IIa Tr. 80-81; III Tr. 18-20, 26-38; V Tr. 50-53. He used some of those funds to repay bank loans he had obtained to finance his securities trading. VII Tr. 5-9, 21.

On July 7, 1988, the trial judge presiding over the lawsuit against Northrup King ordered respondent to distribute the settlement funds. III Tr. 20, 37. To replace the funds stolen from the trust accounts, respondent used $185,000 that he had received from two other clients for the purpose of settling other cases. III Tr. 37-41, 84-89, 217-219. He also used funds from personal bank loans to pay claims under the settlement agreement. As of August 1988, however, he still needed more than $400,000 to pay the remaining claims. III Tr. 41-47, 52-53.

2. On July 19, 1988, Cravath, Swaine & Moore (Cravath), a law firm in New York, arranged to retain Dorsey as local counsel for Grand Metropolitan PLC (Grand Met), a company based in the United Kingdom. Dorsey was retained to represent Grand Met in connection with a potential tender offer for the common stock of Pillsbury Company, a company headquartered in Minnesota. J.A. 95-98, 123-125.

Grand Met and Cravath took extensive steps to protect the confidentiality of the information about the tender offer plan and limited the dissemination of information about the plan to as few people as possible. J.A. 101-103, 107-108, 134-136. Even within Grand Met, only seven or eight people knew the proposed offering price before the announcement of the tender offer. X Tr. 30-31. The efforts to keep the tender offer plans confidential were successful, for Pillsbury stock maintained a steady price before the tender offer was announced, and investors

discounted, as unfounded gossip, media stories suggesting a possible takeover of Pillsbury. J.A. 65-67, 71-72, 81-82, 104-106, 111.

Dorsey took similar steps to protect the confidentiality of the information about Grand Met's tender offer plans. Dorsey limited the dissemination of information to as few people as possible within the firm; the firm's file on the matter was opened under the name of Cravath, and the subject of the representation was described under the heading "general matters." J.A. 114-116. The firm also had a written policy requiring that the affairs of a client be kept strictly confidential. J.A. 26-31.

Thomas Tinkham, the chairman of the litigation department at Dorsey, was the partner assigned to head the Dorsey team of attorneys handling litigation matters related to Grand Met's acquisition of Pillsbury. Tinkham was scheduled to meet with partners from the law firm's corporate department on August 26, 1988, to discuss whether the firm should continue to represent Grand Met in its attempt to acquire a local company. A few days before that meeting, respondent stopped by Tinkham's office. Respondent told Tinkham that he understood that Tinkham was working on the Pillsbury takeover.[1] Respondent expressed an interest in working on the case, stating that he hated Pillsbury. Tinkham declined respondent's offer to work on the case, and he found that offer to be unusual, because respondent was more senior than Tinkham. Tinkham mentioned, however, that he was going to a

[1] The record does not indicate how respondent first learned of that closely guarded information. Respondent used his conversation with Tinkham, however, to confirm his knowledge of confidential firm and client information, and a properly instructed jury found that respondent had "gained access to, and then misappropriated material, nonpublic information, which was to be used only for Grand Met's purposes through a relationship of trust and confidence." J.A. 195.

meeting with partners from the corporate department to discuss whether the law firm should continue its representation against a local company. Tinkham asked respondent what position he should take at the meeting, and respondent expressed agreement with Tinkham that Dorsey should continue the representation. J.A. 125-133.[2]

3. Respondent began buying call options for Pillsbury stock on August 18, 1988.[3] By August 25, 1988, he had accumulated 500 Pillsbury September call options—each option giving him a right to purchase 100 shares of Pillsbury stock at $40 per share, on or before September 17, 1988. V Tr. 163-166; VI Tr. 18-20, 202-203; VIII Tr. 26-28; GX 34a. On August 29, 1988, respondent purchased 100 Pillsbury call options with an expiration date of October 22, 1988. The next day, he purchased 100 more Pillsbury October call options, as well as 50 Pillsbury call options with an expiration date of November 19, 1988. J.A. 55, 145. By the end of September 1988, he had amassed 2,500 Pillsbury call options, which at the time made him the largest individual investor in such options in the world. J.A. 85, 148, 157-160. He also purchased 5,000 shares of Pillsbury common stock on September 20, 1988, for just under $39 per share. J.A. 58, 154-156. He financed those

[2] At trial, Tinkham testified that he did not remember whether he specifically identified Grand Met as the client during his conversation with respondent. J.A. 132. Dorsey decided to continue its representation of Grand Met at the August 26 meeting, but withdrew its representation on September 9, 1988. J.A. 118.

[3] A call option gives the holder the right to buy "shares of a particular stock or stock index at a predetermined price before a preset deadline, in exchange for a premium. For buyers who think a stock will go up dramatically, call options permit a profit from a smaller investment than it would take to buy the stock." John Downes & Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms* 70 (4th ed. 1995). See also J.A. 144-147.

purchases in part with $200,000 in proceeds from a bank loan on August 24, 1988, which was secured by a mortgage on his home. V Tr. 168, 170-171, 216; VI Tr. 48-49, 121-122, 173-175, 204, 206-208; J.A. 161-162.

On October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock. Following the announcement, the price of Pillsbury stock rose from $39 per share to nearly $60 per share. J.A. 100. Respondent then sold all his Pillsbury call options. J.A. 55, 140-141.[4] He also sold the 5,000 shares of Pillsbury common stock that he had acquired. J.A. 56. Confirmations of his trades in Pillsbury securities were mailed to him by his brokerage firms. J.A. 140, 141, 149.

Respondent made a total profit of more than $4.3 million on his trades of Pillsbury securities. J.A. 56. 162. He used those profits to replenish the funds he had stolen from the firm's trust accounts. III Tr. 47-56, 203-209; V Tr. 186-188.

4. Respondent was convicted on 57 counts arising out of his trading in Pillsbury securities, including 20 counts of mail fraud, 17 counts of securities fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5, and 17 counts of fraudulent trading in connection with a tender offer, in violation of Section 14(e) of the Exchange Act and Rule 14e-3(a). The court of appeals reversed all the convictions. Pet. App. 1a-39a.

a. The court of appeals noted that respondent's convictions under Section 10(b) and Rule 10b-5 were based solely on the "misappropriation theory" of securities fraud. The misappropriation theory, the court explained, "has been held to impose § 10(b) and Rule 10b-5 liability for fraud on an individual who (1) misappropriates material nonpublic

[4] Because the price of Pillsbury stock had not reached $40 per share by September 17, the September call options had expired worthless. J.A. 144-145, 146, 160.

information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock." Pet. App. 9a (internal quotation marks omitted). Specifically, the court noted, respondent was alleged to have "breached a fiduciary duty to Dorsey & Whitney and Grand Met when, through his employment at Dorsey & Whitney, he obtained confidential, material, and nonpublic information concerning Grand Met's interest in acquiring Pillsbury, and subsequently used that information as a basis for trading in Pillsbury securities." *Id.* at 10a.

The court of appeals held that the misappropriation theory is not a valid basis for liability under Section 10(b) and Rule 10b-5. Pet. App. 11a-24a. It concluded that the misappropriation theory does not meet Section 10(b)'s requirement of a "deceptive device," in that it "permits the imposition of § 10(b) liability based upon the mere breach of a fiduciary duty without a particularized showing of misrepresentation or nondisclosure," *id.* at 12a-13a, and "the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not deception within the meaning of § 10(b)," *id.* at 13a.

The court of appeals also concluded that the misappropriation theory does not meet Section 10(b)'s requirement that the fraud be employed "in connection with the purchase or sale of any security." According to the court, the theory "permits liability for a breach of a duty owed to individuals who are unconnected to and perhaps uninterested in a securities transaction, thus rendering meaningless the 'in connection with . . .' statutory language." Pet. App. 13a. Since, the court stated, "the principal concern of section 10(b) is the protection of purchasers and sellers of securities," it concluded that "only a breach of a

duty to parties to the securities transaction or, at the most, to other market participants such as investors, will be sufficient to give rise to § 10(b) liability." *Id.* at 13a-14a.

b. The court of appeals also reversed respondent's convictions under Section 14(e) and Rule 14e-3(a). It held that Rule 14e-3(a), which prohibits certain persons from trading while in possession of material, nonpublic information relating to a tender offer obtained from the bidder or the target, exceeds the SEC's rulemaking authority under Section 14(e) because the Rule applies whether or not such trading breaches a fiduciary duty. Pet. App. 24a-36a.

The court acknowledged that Section 14(e) authorizes the SEC to "define" and "prescribe means reasonably designed to prevent" "acts and practices" which are "fraudulent" in connection with tender offers. Pet. App. 28a. It concluded, however, that, while "the enabling provision of § 14(e) permits the SEC to identify and regulate those 'acts and practices' which fall within the § 14(e) legal definition of 'fraudulent,'" it "does not grant the SEC a license to redefine the term." *Id.* at 28a-29a. It also concluded that the SEC's additional authority under the statute to "prescribe means reasonably designed to prevent" fraudulent acts was of no significance; "this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule." *Id.* at 35a.

As to the meaning of "fraudulent" in Section 14(e), the court found "no indication that the term was to have a meaning different from its common legal definition." Pet. App. 29a. The court concluded "that 'fraudulent' under § 14(e) must be interpreted to require the breach of a fiduciary obligation or similar trust relationship." *Id.* at 32a. The court thus held that "the SEC exceeded its rulemaking authority under § 14(e) when it promulgated

Rule 14e-3(a) without including a requirement of a breach of a fiduciary obligation." *Id.* at 36a.

c. Based on its reversal of the securities fraud convictions, the court of appeals also reversed respondent's mail fraud convictions under 18 U.S.C. 1341. Pet. App. 36a-37a. It noted that "[t]he mere fact that [respondent's] securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed." *Id.* at 36a. In the court's view, however, "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." *Id.* at 37a. "Because [respondent's] conduct did not constitute securities fraud," the court reasoned that "there was no fraud upon which to base the mail fraud charges." *Ibid.*[5]

d. Judge Fagg dissented. He believed that both the misappropriation theory of liability under Section 10(b) and SEC Rule 14e-3(a) are valid. He therefore would have affirmed respondent's convictions on all 57 counts. Pet. App. 38a-39a.

SUMMARY OF ARGUMENT

I. The misappropriation of material, nonpublic information for securities trading violates Section 10(b) and Rule 10b-5. Under the misappropriation theory, it is a "deceptive device" "in connection with the purchase or sale of any security" for a person to misappropriate confidential information, in breach of a fiduciary or similar duty of trust and confidence, by using that information in securities trading. The theory satisfies Section 10(b)'s

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[5] The court also overturned respondent's conviction for engaging in a monetary transaction in property derived from an unlawful activity under 18 U.S.C. 1957, and his convictions for money laundering under 18 U.S.C. 1956(a)(1)(B)(i), because "they were predicated on the securities fraud or mail fraud counts." Pet. App. 37a.

requirement of "decepti[on]," because the misappropriator, in order to convert the information to his own benefit by trading on it, deceives the information's legitimate possessor into believing that he is acting as a faithful agent. The theory also satisfies Section 10(b)'s requirement that the deception be "in connection with" a securities transaction, because the information is converted for the sole purpose of, and derives its personal value to the misappropriator only from its utility in, securities trading. Indeed, the act of misappropriation is completed by the exploitation of the converted information in the securities market.

The deception in a misappropriation case is practiced on the source of the information, rather than on the investor with whom the misappropriator trades. That fact, however, does not make Section 10(b) inapplicable. Section 10(b) authorizes the SEC to promulgate regulations "as necessary or appropriate in the public interest *or* for the protection of investors" (emphasis added). Even when deception is not practiced directly on the person on the other side of a securities trade, the SEC has the authority to prohibit deception that would have a deleterious effect on the integrity of the securities markets and investor confidence in those markets. The federal securities laws are not limited to the protection of investors. See *United States* v. *Naftalin*, 441 U.S. 768 (1979).

The misappropriation theory is consistent with this Court's decisions in *Chiarella* v. *United States*, 445 U.S. 222 (1980), *Dirks* v. *SEC*, 463 U.S. 646 (1983), and *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). It also promotes the underlying purposes of the securities laws. The proscription of misappropriation strengthens the confidence of investors that the securities markets are not characterized by the misuse of inside information based on illegal acts, and it

protects legitimate investment in information gathering and analysis. Finally, the theory has been validated by amendments to the securities laws.

II. Rule 14e-3(a) is a valid exercise of the SEC's rulemaking authority under Section 14(e). Section 14(e) forbids fraudulent practices in the tender offer setting and authorizes the SEC to promulgate rules, for purposes of that subsection, that "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." Rule 14e-3(a) prohibits trading by a person in possession of material, nonpublic information about a tender offer that he knows or has reason to know comes from the bidder, the target, or an insider or adviser of either, without requiring a showing that trading on such undisclosed information violates any fiduciary duty.

Rule 14e-3(a) is within the SEC's broad authority under Section 14(e) to proscribe deleterious practices in connection with tender offers. First, the SEC may use its "defining" power under Section 14(e) to identify fraudulent practices in the tender offer setting beyond the proscriptions of common law fraud and other provisions of the securities laws. In prohibiting trading in the tender offer setting on undisclosed information, even absent a fiduciary (or similar) duty to speak, the SEC validly exercised its power to "define" such acts as are fraudulent or deceptive. The "defining" power would be a virtual nullity were the SEC not permitted to go beyond common law fraud (which is separately prohibited in the first sentence of Section 14(e)). Second, the SEC may also "prescribe means reasonably designed to prevent[] such acts and practices as are fraudulent, deceptive, or manipulative" in connection with tender offers. That power plainly authorizes prophylactic rules. Thus, the SEC may "prevent" difficult-to-detect fraudulent practices that are likely to occur in

connection with tender offers by establishing a flat ban on a class of trading on undisclosed material information.

III. The mail fraud statute is applicable to fraudulent schemes to misappropriate confidential information for securities trading. In *Carpenter* v. *United States*, 484 U.S. 19 (1987), this Court held that an employee's deceptive misuse of confidential business information for personal gain in securities trading violated the mail fraud statute. *Carpenter* makes clear that the mail fraud statute prohibits that form of fraud whether or not the same acts violate the federal securities laws. The same conclusion applies here to respondent's conversion of information that belonged to his law firm and its client for the purpose of his personal profit in securities trading.

ARGUMENT

I. TRADING IN SECURITIES ON MISAPPROPRIATED INFORMATION VIOLATES SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5

Under the misappropriation theory of insider trading liability, it is a "deceptive device" "in connection with the purchase or sale of any security" when a person, in breach of a fiduciary or similar duty of trust and confidence, converts his principal's information by using that information for his personal benefit in securities trading. That theory of liability is consistent with the texts of Section 10(b) and Rule 10b-5.[6] It also accords with the decisions of this

[6] Section 10(b) of the Exchange Act makes it unlawful for "any person"

> To use or employ, in connection with the purchase or sale of any security[,] * * * any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. 78j(b). The SEC's Rule 10b-5 implements that statutory proscription by providing that it is unlawful for any person "[t]o employ any device, scheme, or artifice to defraud * * * or [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person[] in connection with the purchase or sale of any security." 17 C.F.R. 240.10b-5(a) and (c).

Court construing those provisions. Finally, the theory promotes the underlying purposes of those provisions, and it has been validated by legislation recently enacted by Congress. The court of appeals therefore erred in reversing respondent's convictions under the misappropriation theory.

A. The Misappropriation Theory Falls Within Section 10(b)'s Coverage Of "Deceptive Devices" "In Connection With" Securities Transactions

There are two theories of insider trading liability under Section 10(b). Under the "classical theory," corporate officers, directors, and other insiders violate Section 10(b) and Rule 10b-5 when they trade in their own corporation's securities on material, nonpublic information. See *Dirks* v. *SEC*, 463 U.S. 646, 653 (1983); *Chiarella* v. *United States*, 445 U.S. 222, 226-227 (1980); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961). Trading on undisclosed material information by corporate insiders is a "deceptive device" because the insider has a fiduciary duty to the corporation's shareholders not to take unfair advantage of them for personal gain. See *Chiarella*, 445 U.S. at 228-229. Accordingly, an insider who engages in a transaction in his own corporation's stock must disclose material, non-

public information before trading; otherwise, he must abstain from trading. See *id.* at 227-228.[7]

Under the misappropriation theory of insider trading, a person commits fraud on the source of information for securities trading when he uses confidential information for his trading in a breach of a fiduciary or similar duty owed to the source. The misappropriation theory protects the integrity of the securities markets against abuses by "outsiders" to a corporation who have access to confidential information that will affect that corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders. For example, an employee of an investment adviser may learn that his firm intends to recommend that clients buy stock in a certain corporation; a deceitful employee may then, in advance of the recommendation, improperly trade for his personal benefit to take advantage of an anticipated rise in price. Or (as in this case) an attorney may learn, in the course of his employment, that a client of his firm plans to acquire a target company; a dishonest attorney may then improperly exploit that information by purchasing securities in the target company, before the announcement of the

[7] The classical theory reaches transactions with existing shareholders as well as persons who become shareholders by purchasing from the insider. *Chiarella*, 445 U.S. at 227 n.8; *Cady, Roberts*, 40 S.E.C. at 914 n.23. It also applies to trading by "temporary insiders," such as attorneys, underwriters, accountants, and consultants who become fiduciaries of the shareholders when, because of their "special confidential relationship" with the business, they receive access to confidential corporate information to be used solely for corporate purposes. *Dirks*, 463 U.S. at 655 n.14. And a "tippee" who receives confidential information about a corporation from an insider or other fiduciary of the firm, knowing or having reason to know that the tipper has breached his fiduciary duty by disclosing the information for his personal benefit, inherits the tipper's fiduciary duty and thereby assumes the duty to disclose or abstain. *Id.* at 660, 662.

acquisition causes the target's stock price to soar. In such cases, a trusted agent defrauds the legitimate owner of the right of exclusive use of its information and reaps illicit profits by employing the information in securities trading.

In this case, respondent unquestionably had a fiduciary obligation to Grand Met and Dorsey not to abuse his position by converting information about Grand Met's tender offer plans to his own benefit. By deceiving his firm and its client into believing that he remained a loyal partner and agent, while in fact pursuing personal gain by trading on their information, respondent was able to earn enormous and virtually risk-free profits in the securities markets. Such trading on converted confidential information is a form of fraud that poses a serious threat to investor confidence in honest securities markets. It therefore implicates Section 10(b)'s protections against fraud in connection with securities trading.

The court of appeals concluded, however, that the misappropriation theory could not be squared with the language of Section 10(b). The court believed that the theory does not satisfy either the statute's requirement of "deceptiti[on]" or its requirement that the deception be "in connection with" the purchase or sale of a security. Pet. App. 11a-12a, 13a-15a. The court of appeals correctly noted that, "[w]ith respect * * * to * * * the scope of conduct prohibited by § 10(b), the text of the statute controls [this Court's] decision." *Id.* at 7a (quoting *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994)). But contrary to the court of appeals' conclusion, the misappropriation theory is firmly grounded in the text of Section 10(b).[8]

[8] This Court reserved judgment on the validity of the misappropriation theory in *Chiarella*, 445 U.S. at 236, and was evenly divided over

1. *Misappropriation is a "deceptive device or contrivance."* Section 10(b) makes it unlawful for a person to use "*any* manipulative or deceptive device or contrivance" in connection with the purchase or sale of a security (emphasis added). Section 10(b) does not require that the deception take a particular form; it prohibits "*all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 11 n.7 (1971); see also *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972). Section 10(b) "must be read flexibly, not technically and restrictively," *Bankers Life*, 404 U.S. at 12, for it was framed as a "catch-all" provision to reach all "cunning devices" related to securities transactions. See *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202 (1976) (quoting *Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate*

its validity in *Carpenter* v. *United States*, 484 U.S. 19, 24 (1987). Both before and since *Carpenter*, the misappropriation theory has been a cornerstone in the SEC's efforts to combat the deceptive misuse of confidential information in the nation's securities markets. The theory has been used in the past 15 years in scores of civil and criminal cases, including some of the most significant securities fraud cases of that period. See, *e.g.*, *SEC* v. *Drexel Burnham Lambert, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. June 20, 1989) (consent judgment); *SEC* v. *Siegel*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,123 (S.D.N.Y. Feb. 13, 1987) (consent judgment); *SEC* v. *Boesky*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. Nov. 14, 1986) (consent judgment); *SEC* v. *Levine*, No. 86 Civ. 3726 (S.D.N.Y. May 12, 1986) (consent judgment). It has also formed the basis of many criminal prosecutions. See, *e.g.*, *United States* v. *Newman*, 664 F.2d 12 (1981), aff'd after remand, 722 F.2d 729 (2d Cir.) (Table), cert. denied, 464 U.S. 863 (1983); *United States* v. *Teicher*, 987 F.2d 112 (2d Cir.), cert. denied, 510 U.S. 976 (1993).

and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934) (statement of Thomas Corcoran)). And while "what [Section 10(b)] catches must be fraud," *Chiarella*, 445 U.S. at 235, misappropriation is a classic form of fraud.

Misappropriation fits well within the language of Section 10(b). When an agent uses his agency relationship to convert confidential information entrusted to him by his principal, he employs a "deceptive device." Such an unfaithful agent maintains a pretense of loyalty to the principal while secretly converting the principal's information for personal gain. Such conversion is a well recognized species of fraud. As the Court made clear in *Carpenter* v. *United States*, 484 U.S. 19 (1987), which involved the mail fraud statute's proscription of any "scheme or artifice to defraud," fraud includes the embezzlement of confidential information, *i.e.*, "the fraudulent appropriation to one's own use of the [information] entrusted to one's care by another." *Id.* at 27 (quoting *Grin* v. *Shine*, 187 U.S. 181, 189 (1902)). In *Carpenter*, the Court held that an employee's undertaking not to reveal his employer's confidential information "became a sham" when the employee violated his duty by providing the information to co-conspirators in a scheme to obtain trading profits. *Ibid.* See also *United States* v. *Procter & Gamble Co.*, 47 F. Supp. 676, 678 (D. Mass. 1942); Restatement (Second) of Agency § 395 (1958). Since "it is impossible for a person to embezzle the [property] of another without committing a fraud upon him," *Grin* v. *Shine*, 187 U.S. at 189, misappropriation may be considered, as it was in *Carpenter*, a "'garden variety' type of fraud," *Bankers Life*, 404 U.S. at 11 n.7.[9]

[9] The court of appeals rejected reliance on *Carpenter*'s interpretation of "scheme to defraud" in the mail fraud statute because it believed that *Santa Fe Industries* v. *Green*, 430 U.S. 462 (1977), "made

The court of appeals erred in concluding that the misappropriation theory permits liability on the mere breach of a fiduciary duty, without deception, in conflict with *Santa Fe Industries* v. *Green*, 430 U.S. 462 (1977). Pet. App. 11a-12a. *Santa Fe* involved a "short-form" merger, effected by majority shareholders, that was alleged to be substantively unfair to minority shareholders. The Court assumed, for the purpose of deciding the case, that the merger terms were grossly undervalued, in breach of a state-law fiduciary duty to minority shareholders. The Court concluded, however, that there was no "deception" within the meaning of Section 10(b) because the minority shareholders, presented with the choice of accepting the merger terms or seeking an appraisal in state court, "were furnished with all relevant information on which to base their decision," 430 U.S. at 474, including an appraisal that called into question the substantive fairness of the merger terms, *id.* at 468-469. *Santa Fe* held that a mere

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clear that in construing § 10(b) resort could not be had to analogous federal statutes." Pet. App. 20a. *Santa Fe*'s caution against importing into the securities laws all concepts of fraud appearing in other federal statutes (430 U.S. at 471 & n.11) does not undermine the relevance of *Carpenter* here. In *Santa Fe*, the Court noted that one of the cases consulted by the court of appeals for an analogy, *Pepper* v. *Litton*, 308 U.S. 295 (1939), involved disallowance of a bankruptcy claim on equitable grounds, while another case, *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), had construed the Investment Advisers Act of 1940, which was intended to establish federal fiduciary standards for investment advisers. 430 U.S. at 471 n.11. The Court did not suggest that traditional concepts of fraud and deception, as incorporated into federal criminal statutes, could not be consulted for guidance on the reach of Section 10(b). The mail fraud statute is a particularly apt source of guidance here, because it (like Section 10(b)) has long been held to require deception, not merely the breach of a fiduciary duty. See *Post* v. *United States*, 407 F.2d 319, 329 (D.C. Cir. 1968), cert. denied, 393 U.S. 1092 (1969).

breach of fiduciary duty, without deception or manipulation, does not violate Section 10(b), see *id.* at 475-476; it did not hold that a breach of fiduciary duty that *does* involve deception is outside the reach of Section 10(b).

The misappropriation theory, by definition, requires deception. Conversion of confidential information by its very nature involves deception, for the scheme's success depends on the agent's lulling the principal into believing that the agent is trustworthy. "The actual deception that is practised is in the continued representation of the employee to the employer that he is honest and loyal to the employer's interests." *Procter & Gamble*, 47 F. Supp. at 678; see also *United States* v. *Buckner*, 108 F.2d 921, 926 (2d Cir.) (affirming mail fraud conviction on theory that "[u]sing a fiduciary position * * * to obtain secret profits based upon inside information is not only a breach of trust, but an active fraud"), cert. denied, 309 U.S. 669 (1940). Accordingly, *Santa Fe*, which involved a transaction in which all material facts were fully disclosed, does not create doubt that misappropriation in breach of a fiduciary or similar duty is "deceptive."

The court of appeals also suggested that the misappropriation theory falls outside Section 10(b) because it does not require an express misstatement of fact or nondisclosure in breach of a duty to speak. Section 10(b)'s coverage of "deceptive device[s]," however, reaches deceptive *acts* as well as statements and omissions, and such acts have long been understood to constitute fraud.[10] See

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[10] A legal dictionary in use when Section 10(b) was drafted shows that the concept of deception was not viewed at that time as limited to express statements and omissions, but included misleading conduct as well. See *Black's Law Dictionary* 529 (3d ed. 1933) ("DECEPTION. The act of deceiving; intentional misleading by falsehood spoken *or acted*.") (emphasis added). Contemporary definitions are in accord. See *The Random House Unabridged Dictionary of the English*

Shushan v. *United States*, 117 F.2d 110, 115 (5th Cir.) ("A scheme to get money unfairly by obtaining and then betraying the confidence of another * * * would be a scheme to defraud though no lies were told."), cert. denied, 313 U.S. 574 (1941). Section 10(b) therefore readily applies to one who misappropriates information with which he is entrusted in violation of his "implicit representation that he would not convert the thing to his own use." Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 Hofstra L. Rev. 101, 119 (1984); see *Carpenter*, 484 U.S. at 27-28 (employee's promise not to misuse confidential information "became a sham" when he did so, "all the while pretending to perform his duty of safeguarding it").[11]

In any event, misappropriation will often involve overt lies. Here, for example, respondent, in his conversation with Thomas Tinkham, feigned an interest in working on

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Language 516 (2d ed. 1987) ("deceive * * * 1. to mislead by a false *appearance* or statement") (emphasis added). Section 10(b)'s prohibition of any "deceptive device or contrivance" thus implies coverage of the full range of schemes to deceive, not just statements or omissions. By contrast, narrower language in Section 17(a)(2) of the Securities Act of 1933, 15 U.S.C. 77q(a)(2), reaches only "any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."

[11] The court of appeals mistakenly relied on *Central Bank*'s statement that Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." 511 U.S. at 177. The Court in *Central Bank* was not addressing whether a "deceptive device" might include deceptive acts other than misrepresentation or lack of disclosure. Rather, the Court was examining only whether there is a private right of action against a person who aids or abets a violation of Section 10(b) but does not himself engage in "deception." See *id.* at 174, 177-178; see also p. 29, *infra* (discussing *Central Bank*).

litigation involving the Pillsbury takeover—a pretense designed to elicit confirmation of the planned takeover. See pp. 4-5, *supra*. The deception in a case of misappropriation of confidential information also involves a breach of a duty to disclose, for an agent who wishes to use his principal's confidential information for his own benefit must obtain the principal's consent and disclose all relevant facts. See Restatement (Second) of Agency § 395 & cmt. c (1958). And, as one commentator has noted, "[f]ew if any breaches of loyalty are done without some effort to avoid detection." Donald C. Langevoort, *Fraud and Deception by Securities Professionals*, 61 Tex. L. Rev. 1247, 1266 (1983). Misappropriation of confidential information therefore satisfies Section 10(b)'s requirement of deception.

2. *The misappropriation theory meets the "in connection with" requirement.* The misappropriation of confidential information for securities trading also satisfies Section 10(b)'s requirement that the deception be "in connection with" the purchase or sale of a security. Here, the misappropriated information had personal value to respondent only because of its utility in securities trading; indeed, his misappropriation was not complete until he traded on the information. Respondent's fraud consisted of the deceptive use of the information about Grand Met's plans *for the purpose* of respondent's trading; the trading was an essential element of respondent's "deceptive device." The misappropriation theory thus depends on an inherent connection between the deceptive conduct and the purchase or sale of a security. Cf. *Bankers Life*, 404 U.S. at 12-13 (fraud was "in connection with" sale of securities when corporate insider induced corporation to sell Treasury bonds so that insider could misappropriate the proceeds of the sale).

The fact that respondent practiced his deception on the source of his information rather than on the investors who sold the securities does not defeat the application of Section 10(b). The statute does not proscribe deception "on a purchaser or seller of a security"; it applies to any deceptive device "in connection with the purchase or sale of any security." Moreover, Section 10(b) authorizes the SEC to prohibit deceptive devices "as necessary or appropriate in the public interest *or* for the protection of investors" (emphasis added). Consistent with the breadth of the statutory language, Section 10(b)'s purposes extend beyond the prevention of fraud perpetrated directly on purchasers and sellers. The SEC thus has the authority to prohibit deceptive acts that, it concludes, would have a deleterious effect on the integrity of the securities markets and on investor confidence in those markets, even if the deception is not practiced directly on the person on the other side of a securities trade. See also 15 U.S.C. 78b (purpose of Exchange Act is "to insure the maintenance of fair and honest markets").

In *United States* v. *Naftalin*, 441 U.S. 768 (1979), the court rejected the contention that Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. 77q(a)(1)—which prohibits any device, scheme, or artifice to defraud "in the offer or sale of any securities"—requires that the deception be practiced on the person on the other side of a securities trade. The Court found no merit in the view that Congress's concern in enacting the Securities Act of 1933 "was limited to investors," and noted that "the welfare of investors and financial intermediaries are inextricably linked—frauds perpetrated upon either business or investors can redound to the detriment of the other and to the economy as a whole." See 441 U.S. at 775-776. *Naftalin* involved the prosecution of an investor who directed his broker to sell certain shares, falsely representing to the broker that he owned the shares; in fact, the investor was "selling short" and did not have the means to make covering purchases when the market prices of the shares that he "sold" rose. The brokers who were deceived suffered losses, but the investors who actually purchased the shares did not. Naftalin argued that the 1933 Act's prohibition against fraud "in" the offer or sale of securities was narrower than Section 10(b)'s proscription against deception "in connection with" a purchase or sale, and so did not reach deception of brokers. While expressing doubt that the phrases had a different scope, the Court, even on the assumption that "in" was narrower than "in connection with,"[12] rejected the argument that the 1933 Act was limited to frauds on investors. See *id.* at 773 & n.4. If fraud "in" a securities transaction does not require fraud on an investor, then deception "in connection with" a securities transaction also does not.

Nor is the misappropriation theory vulnerable on the view that it "transforms section 10(b) from a rule intended to govern and protect relations among market participants who are owed duties under the securities laws into a federal common law governing and protecting any and all trust relationships." *United States* v. *Bryan*, 58 F.3d 933, 950 (4th Cir. 1995). The theory applies only when the breach of duty involves misappropriation of information, and only when the information is used as the basis of a

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[12] Compare *Dunn* v. *Commodity Futures Trading Commission*, No. 95-1181 (Feb. 25, 1997), slip op. 5 (in construing the phrase "transactions *in* foreign currency" in 7 U.S.C. 2(ii) (emphasis added), the Court noted that the word "in" "is usually thought to be 'synonymous with [the] expressions "in regard to," "respecting," [and] "with respect to"'").

trade in securities.[13] Furthermore, the classical theory of insider trading itself is premised on fiduciary (and similar) relationships arising under common law. See *Chiarella*, 445 U.S. at 227-228 (describing "common law" disclosure requirements based on fiduciary duties); *Dirks*, 463 U.S. at 655 & n.14 (applying disclose-or-abstain rule to advisers, such as attorneys, who "may become fiduciaries of the shareholders"). The misappropriation theory likewise describes consequences for fiduciaries (and those in similar positions of trust and confidence) who engage in deceptive breaches in connection with securities transactions.

The task of identifying those relationships in which the improper use of confidential information for personal gain constitutes a deceptive practice under Section 10(b) is not unduly difficult, and it parallels the similar inquiry under the mail fraud statute. See *Carpenter*, *supra*. Respondent's deception of his law firm and its client, for example, involved relationships that "[t]he common law has recognized * * * are inherently fiduciary." *United States* v. *Chestman*, 947 F.2d 551, 568 (2d Cir. 1991) (opinion of Meskill, J.) (en banc) ("Counted among these hornbook fiduciary relations are those existing between attorney and client, * * * [and] principal and agent."), cert. denied, 503 U.S. 1004 (1992).

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[13] The misappropriation theory would not, in contrast, apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities. In those cases, the proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained. Material, nonpublic information affecting security prices, however, is valuable to a misappropriator because it enables him to make profits in the securities market. Indeed, the fraud is not consummated until the information is used in trading.

The court of appeals objected to the misappropriation theory on the ground that it protects from fraud entities other than market participants. See Pet. App. 15a-16a; accord *Bryan*, 58 F.3d at 946-949. Respondent, however, misappropriated information about an upcoming takeover from the bidder and a law firm retained to represent it. The proper functioning of the securities markets requires that the bidder (who is poised to become a "market participant") be protected against the fraudulent use of confidential business plans. The same protection is also needed for the law firms and investment advisers who represent and counsel bidders in transactions. Those advisers are properly viewed as "temporary insiders," see note 7, *supra*, and they necessarily learn the confidential business plans of market participants. It would be pointless to protect the market participants themselves against fraud in connection with securities trading while leaving unprotected the confidential advisers who are indispensable to the market participants' actions.

Nothing in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), suggests that the direct protection of investors against fraud is the exclusive concern of Section 10(b). There, the Court limited the class of persons who may bring an implied private right of action under Section 10(b) and Rule 10b-5 to those who have actually purchased or sold securities. The Court recognized that purchaser-seller standing rule largely because of "policy considerations" (*id.* at 737) involving the dangers of litigation by investors who did not make an actual purchase or sale but who might later claim that they would have done so in the absence of alleged deceptive conduct by others. While the Court did note that Section 10(b)'s wording "is directed toward injury suffered 'in connection with the purchase or sale' of securities," *id.* at 733, that observation was intended to distinguish an actual "sale" from a general

selling program or an offer to sell. See *id.* at 733 n.5. The Court did not purport to catalogue the types of injuries that might be suffered "in connection with [a] purchase or sale." And in *Naftalin*, the Court made clear that the purchaser-seller standing rule of *Blue Chip Stamps* is "inapplicable" to a criminal prosecution. 441 U.S. at 774 n.6. See also *Blue Chip Stamps*, 421 U.S. at 751 n.14 (purchaser-seller rule "imposes no limitation on the standing of the SEC to bring actions for injunctive relief"); *Chiarella*, 445 U.S. at 238 (Stevens, J., concurring); *Holmes* v. *Securities Investor Protection Corp.*, 503 U.S. 258, 281, 284, 285 (1992) (O'Connor, J., concurring in part and concurring in the judgment); *id.* at 289-290 (Scalia, J., concurring in the judgment).

B. The Misappropriation Theory Is Consistent With The Decisions Of This Court

Although the text of Section 10(b) readily supports the misappropriation theory, the court of appeals read this Court's decisions in *Chiarella* v. *United States*, 445 U.S. 222 (1980), *Dirks* v. *SEC*, 463 U.S. 646 (1983), and *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), to hold that "only a breach of a duty to parties to the securities transaction or, at the most, to other market participants such as investors, will be sufficient to" violate Section 10(b). Pet. App. 13a-14a. None of those cases, however, stands for that proposition.

Chiarella involved securities trades by a printer employed at a shop that had been engaged to print announcements for companies planning takeover bids. After deducing the identity of the target companies from the materials furnished by the acquiring companies, Chiarella bought shares of the targets before the bids were announced, expecting (correctly) that the share prices would rise upon announcement. Even though Chiarella had

gained access to, and traded on, information not available to the market, the Court concluded that he had not violated Section 10(b) by trading without disclosing that information, because he had not been shown to have breached any duty to disclose to his trading partners (the target companies' shareholders). 445 U.S. at 232-233. The Court explained that there is no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information," and that a duty to disclose, or abstain from trading on, material, nonpublic information must arise "from a specific relationship between two parties." *Id.* at 233.

The Court did not hold in *Chiarella* that the *only* relationship that gives rise to liability when trading on undisclosed information is the relationship between a corporation's insiders and shareholders. The government argued in this Court that Chiarella's misappropriation of information from his employer for securities trading, in violation of a duty to the acquiring companies, constituted fraud in connection with the purchase or sale of a security under Section 10(b). 445 U.S. at 235-236. The Court declined to reach that theory, because the jury had not been instructed on it. *Id.* at 236-237. Four Justices, however, voiced support for that theory, see *id.* at 239 (Brennan, J., concurring in the judgment); *id.* at 240-243 (Burger, CJ., dissenting); *id.* at 245 (Blackmun, J., joined by Marshall, J., dissenting), and a fifth Justice stated that the "Court correctly does not address" the issue, but "wisely leaves the resolution of this issue for another day," *id.* at 238 (Stevens, J., concurring). *Chiarella* thus left open the question presented in this case.

Dirks involved an investment analyst who received information from Secrist, a former insider of a corporation with which Dirks had no connection, indicating that the corporation had engaged in massive fraud. Secrist urged

Dirks to investigate the fraud; after doing so and verifying the information, Dirks recommended to his clients that they sell their holdings in that company. Viewing Dirks as a "tippee" of Secrist, the SEC concluded that Dirks had inherited, and had violated, Secrist's fiduciary duty to the shareholders to disclose or abstain from trading on nonpublic information. 463 U.S. at 649-651.

This Court disagreed, rejecting in particular the argument that Dirks had assumed an insider's duty to disclose or abstain *solely* because he had received nonpublic information. 463 U.S. at 655-658. That argument, the Court concluded, was essentially the same as the one rejected in *Chiarella*, *i.e.*, that all persons with any advantage based on nonpublic information must disclose the information or abstain from trading. *Id.* at 656-657. The Court held, rather, that, because a tippee's duty can be no greater than that of the insider, the tippee assumes a duty to disclose or abstain "only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." *Id* at 660. Because there had been no showing that Secrist had violated any duty by disclosing the nonpublic information about his former employer to Dirks, there was also no violation by Dirks. *Id.* at 665-667.

Dirks did not suggest that a person who gains an informational advantage unlawfully, through misappropriation in breach of a fiduciary duty, may freely trade on that advantage. Indeed, the Court noted in *Dirks* that "[t]here was no expectation by Dirks' sources that he would keep their information in confidence. Nor did Dirks misappropriate or illegally obtain the information about [the corporation]." 463 U.S. at 665. *Dirks*, like *Chiarella*, rejected a "parity of information" rule. Those cases make clear that disparity of information between parties to a securities trade is not *per se* unfair, and so trading on the

advantage given by such a disparity, *without more*, is not "deceptive." See *id.* at 658-659. But in protecting informational disparities that are the product of *legitimate* activity, see *ibid.* (noting valuable "role of market analysts, which * * * is necessary to the preservation of a healthy market"), *Dirks* did not exempt from Section 10(b) the deceptive conversion of information for securities trading—a patently *illegitimate* activity.

Finally, *Central Bank* involved whether a private action under Section 10(b) and Rule 10b-5 may be brought for aiding and abetting a primary violation of those provisions. 511 U.S. at 167. The Court held that "a private plaintiff may not maintain an aiding and abetting suit under § 10(b)." *Id.* at 191. The Court then added that "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." *Ibid.* The court of appeals relied on that statement as an indication that only purchasers and sellers are protected by Section 10(b). Pet. App. 15a. The context of the *Central Bank*'s discussion makes clear, however, that the Court was discussing only private liability under Section 10(b), in which the *Blue Chip Stamps* purchaser-seller rule applies. See pp. 25-26, *supra*. *Central Bank*, moreover, involved no issue of what deceptive conduct violates Section 10(b); the only issue was whether aiding and abetting another person's deception supports private liability under the provision. *Central Bank*'s rejection of private aiding and abetting liability has no bearing on whether the misappropriation theory is a valid basis for Section 10(b) liability.

C. The Misappropriation Theory Furthers Important Policies Of The Securities Laws And Has Been Accepted As Valid In Amendments To Those Laws

Trading on misappropriated information strikes at the heart of investor confidence in fair and honest securities markets, and it discourages legitimate investment in information gathering and analysis. Those concerns plainly implicate the "public interest" that the SEC may protect by forbidding trading on misappropriated information under Section 10(b) and Rule 10b-5. Congress has confirmed that view by enacting legislation that builds on the misappropriation theory. That legislation further supports the validity of the misappropriation theory.

1. "In the wake of the 1929 stock market crash and in response to reports of widespread abuses in the securities industry, the 73d Congress enacted two landmark pieces of securities legislation: the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act)." *Central Bank*, 511 U.S. at 170-171. The "basic goals" of the Exchange Act are "[t]o provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors, * * * and to provide, to the maximum degree practicable, markets that are open and orderly." H.R. Conf. Rep. No. 229, 94th Cong., 1st Sess. 91-92 (1975).

An essential goal of the Exchange Act is the promotion of investor confidence in the fairness of the markets. See 15 U.S.C. 78b (regulation necessary "to insure the maintenance of fair and honest markets"). Section 10(b) furthers that aim by permitting the Commission to prohibit those "manipulative and deceptive practices which have been demonstrated to fulfill no useful function." S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934). The SEC has made the

judgment that trading on misappropriated information "undermines the integrity of, and investor confidence in, the securities markets." 45 Fed. Reg. 60,412 (1980). That judgment is sound. If investors knew that the SEC and the federal securities laws could not protect the markets against the use of illegally acquired information, and that no amount of research or skill could overcome their informational disadvantage, many would decline to participate in the markets at all, for they would know that they were playing a game in which the dice might, at any time, be loaded.[14] See Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 356 (1979); Nicholas Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 Conn. L. Rev. 1, 19, 33 (1993). Other investors might demand risk premiums to compensate for the fear of overreaching, or engage in corrupt actions to overcome their informational disadvantages. "None of those responses is socially useful." Brudney, 93 Harv. L. Rev. at 356; see *id.* at 334-335. And capital formation would be impaired if investors left the securities markets because of lost confidence in the fairness of those markets (or demanded premiums to compensate for the risk of unfairness)—a point noted twice recently by congressional committees in the course of the enactment of increased sanctions for insider

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[14] The role of the SEC is vital to investor confidence, because, as this Court has noted, "Congress recognized that efficient regulation of securities trading could not be accomplished under a rigid statutory program. As part of the 1934 Act Congress created the Commission, which is provided with an arsenal of flexible enforcement powers." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 195 (1976).

trading. H.R. Rep. No. 355, 98th Cong., 1st Sess. 2 (1983); H.R. Rep. No. 910, 100th Cong., 2d Sess. 8 (1988).[15]

The unfair advantage gained by misappropriation of information could also discourage securities analysts from competing lawfully for information and providing investors with valuable insights into the worth of specific companies. Indeed, the use of misappropriated information in the securities markets may discourage the creation of such information in the first place. See Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 Sup. Ct. Rev. 309, 313. And advance trading on misappropriated information can drive up the cost of transactions by increasing the price that the acquiring company must pay for tendered shares. See Bradford Cornell & Erik Sirri, *The Reaction of Investors and Stock Prices to Insider Trading*, 47 J. Fin. 1031, 1032-1033, 1045-1046 (1992); *SEC* v. *Maio*, 51 F.3d 623, 634 n.12 (7th Cir. 1995); *United States* v. *Newman*, 664 F.2d 12, 17-18 (1981), aff'd after remand, 722 F.2d 729 (2d Cir.) (Table), cert. denied, 464 U.S. 863 (1983). All those consequences harm the public interest, and all support the conclusion that liability for deceptive trading on misappropriated information is consistent with Section 10(b).

2. In 1988, Congress confirmed the validity of the misappropriation theory of liability, when it bolstered sanc-

[15] See also American Bar Ass'n, Comm. on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading*, 41 Bus. Law. 223, 228 (1985); Steven R. Salbu, *Tipper Credibility, Noninformational Tippee Trading, and Abstention From Trading: An Analysis of Gaps in the Insider Trading Laws*, 68 Wash. L. Rev. 307, 328 n.117 (1993); John W. Bagby, *The Evolving Controversy Over Insider Trading*, 24 Am. Bus. L.J. 571, 579 n.55 (1987) (quoting Arthur Levitt, Jr., then chairman of the American Stock Exchange).

tions for insider trading.[16] In the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, § 2(1), 102 Stat. 4677, Congress declared:

> [T]he rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 governing trading while in possession of material, nonpublic information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors.

The House Report accompanying ITSFEA makes clear that Congress intended to validate the misappropriation theory of liability under Rule 10b-5, which is one of the SEC's rules "governing trading while in possession of material, nonpublic information."[17] Following a discussion of *Chiarella*, *Dirks*, *Carpenter*, and the Second Circuit cases upholding the misappropriation theory, the House Report stated: "Under current case law, the SEC must es[t]ablish that the person misusing the information has breached either a fiduciary duty to shareholders or *some other duty* not to misappropriate insider information." H.R. Rep. No. 910, *supra*, at 10 (emphasis added). The

[16] Previously, a 1983 House Report accompanying the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264, cited with approval a Second Circuit decision upholding the misappropriation theory as a valid basis for liability, and noted that the law in this area was "well-developed." H.R. Rep. No. 355, *supra*, at 5 n.8, 13 & n.20. The Report explained that, "[i]n other areas of the law, deceitful misappropriation of confidential information by a fiduciary * * * has consistently been held to be unlawful," and stated that Congress "has not sanctioned a less rigorous code of conduct under the federal securities laws." *Id.* at 5.

[17] Congress also intended that enactment to validate Rule 14e-3(a). See pp. 44-45, *infra*.

fraud should be encompassed within Section 10(b) and Rule 10b-5." *Ibid.*[18]

Congress's validation of the misappropriation theory is also evident from its enactment in ITSFEA of a new Section 20A(a) of the Exchange Act, 15 U.S.C. 78t-1(a). Section 20A(a) provides an express cause of action against any person who violates the Exchange Act "by purchasing or selling a security while in possession of material, nonpublic information," for the benefit of "any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased * * * or sold * * * securities of the same class." Section 20A(a) was "specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory." H.R. Rep. No. 910, *supra*, at 26. In particular, Section 20A(a) rejected the result in *Moss* v. *Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984), in which the court of appeals held that a Rule 10b-5 plaintiff had no cause of action against employees of an investment bank who had purchased a company's stock based on misappropriated nonpublic information that the bank's client intended to launch a tender

[18] Although Congress did not define "insider trading" in ITSFEA, the House Report noted that the Committee was concerned that a statutory definition of that concept could be inadvertently *narrowing*. See H.R. Rep. No. 910, *supra*, at 11. The Committee emphasized that "[t]he legal principles governing insider trading cases" were already "well-established and widely-known," and therefore did not require additional definition. *Ibid.* In context, the Committee Report makes clear that "insider trading," as that term was used in the Report, included "trading and tipping by persons who misappropriate material nonpublic information from sources other than market participants." *Id.* at 10 (discussing *Carpenter*).

offer for that company.[19] In recommending that Congress create the right of recovery rejected in *Moss*, the Committee stated that "the misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful." H.R. Rep. No. 910, *supra*, at 26-27; see also *id.* at 38-39.

This Court has observed that, "once an agency's statutory construction has been 'fully brought to the attention of the public and the Congress,' and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been correctly discerned." *United States* v. *Rutherford*, 442 U.S. 544, 554 n.10 (1979) (citation omitted). In 1988, Congress not only declined to alter the misappropriation theory after considering it closely, it expressly declared approval of that doctrine by positive legislation. See *Red Lion Broadcasting Co.* v. *FCC*, 395 U.S. 367, 380-382 (1969). Accordingly, there is no basis for concluding that the misappropriation theory is inconsistent with Section 10(b).

[19] Although the Second Circuit had previously upheld the misappropriation theory of liability as applied to the same transactions in a criminal prosecution, see *Newman*, *supra*, the court of appeals held that, under *Chiarella*, even though the defendants had committed securities fraud, they had no duty of disclosure to the target's shareholders, as to whom they were "complete stranger[s] who dealt with the sellers * * * only through impersonal market transactions." *Moss*, 719 F.2d at 13 (quoting *Chiarella*, 445 U.S. at 232-233).

II. THE SEC VALIDLY PROMULGATED RULE 14e-3(a) PURSUANT TO ITS RULEMAKING AUTHORITY IN SECTION 14(e) OF THE EXCHANGE ACT

Respondent was convicted of violating Section 14(e) of the Exchange Act and SEC Rule 14e-3(a). Rule 14e-3(a) prohibits anyone (other than the bidder) who possesses material, nonpublic information about a tender offer, which he knows or has reason to know is obtained from the bidder, the target, or an insider or adviser of either, from trading in the shares of companies that will be involved in that tender offer absent public disclosure of the information and its source. A violation of Rule 14e-3(a) does not require proof that the person who traded breached a fiduciary duty in trading, or in acquiring the inside information; it requires only that the person traded while in possession of the nonpublic information.

Because Congress expressly delegated rulemaking authority to the SEC in Section 14(e), Rule 14e-3(a) is valid unless it is "arbitrary, capricious, or manifestly contrary to the statute." *Chevron U.S.A Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984); *Batterton* v. *Francis*, 432 U.S. 416, 424-426 (1977) (legislative regulations are entitled to "more than mere deference or weight"). The court of appeals held that, because Rule 14e-3(a) does not require a breach of fiduciary duty, it exceeds the SEC's rulemaking authority under Section 14(e). Pet. App. 24a-36a. That conclusion is incorrect.

A. The SEC's Rulemaking Power Under Section 14(e) Is Not Limited To Regulating Common Law Fraud Or Practices Covered By Section 10(b)

Section 14(e), which was enacted by Congress as part of the Williams Act in 1968, Pub. L. No. 90-439, § 3, 82 Stat.

457, makes it unlawful "to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer." Section 14(e)'s second sentence, added in the 1970 amendments to the Williams Act, see Act of Dec. 22, 1970, Pub. L. No. 91-567, § 5, 84 Stat. 1497-1498, provides further that the SEC "shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." Section 14(e) thus contains, in the first sentence, a self-operative prohibition against fraud, and contains, in the second sentence, a grant of rulemaking authority to the SEC to delineate the "acts and practices" that shall be considered "fraudulent" within the meaning of Section 14(e) and also to prescribe means reasonably designed to prevent them.

1. The language and structure of Section 14(e) make clear that the SEC's rulemaking authority is not limited, as the court of appeals believed (Pet. App. 28a-29a), to proscribing traditional fraud committed in derogation of fiduciary duties. A reading of Section 14(e) restricting the SEC to "defin[ing]" fraud exactly as courts have already done under the common law renders its defining authority superfluous, in light of Section 14(e)'s self-operative prohibition against "fraudulent * * * acts or practices." That construction would conflict with the settled principle that courts must "give effect, if possible, to every clause and word of a statute." *United States* v. *Menasche*, 348 U.S. 528, 538-539 (1955). The "delegation of rulemaking responsibility [would] become[] a hollow gesture * * because the SEC could never define as fraud anything not already prohibited by the self-operative provision." *United States* v. *Chestman*, 947 F.2d 551, 558 (2d Cir. 1991) (opinion of Meskill, J.), cert. denied, 503 U.S. 1004 (1992).

The court of appeals also believed that the SEC's authority to define fraud under Section 14(e) could reach no further than its authority under Section 10(b). Pet. App. 30a-32a. For that conclusion, the court relied on *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1, 10 & n.10 (1985), where this Court remarked that Section 14(e)'s "broad antifraud prohibition" was "modeled on § 10(b) and Rule 10b-5." *Schreiber*, however, involved only acts that were alleged to violate the self-operative prohibition in the first sentence of Section 14(e)—which does contain language similar to Section 10(b). That case did not involve the SEC's authority in Section 14(e) to define fraudulent acts by regulation.[20]

The express rulemaking authority conferred by Section 14(e) goes well beyond that found in Section 10(b). While Section 10(b) authorizes the SEC only to proscribe "manipulative or deceptive device[s] or contrivance[s]," the second sentence of Section 14(e) authorizes the SEC to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."[21] The textual difference between the two sections results from the fact that Section 14(e)'s rulemaking provision was modeled not on Section 10(b), but on Section 15(c)(2) of the Exchange Act, 15 U.S.C. 78*o*(c)(2). See S. Rep. No. 1125, 91st Cong., 2d Sess. 4 (1970); *Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemptions*

[20] Moreover, *Schreiber* involved acts alleged to be "manipulative" rather than "fraudulent," and the Court has noted that "manipulative" (unlike "fraudulent") is "virtually a term of art when used in connection with the securities markets." 472 U.S. at 6.

[21] The scope of Section 14(e) is, however, narrower than that of Section 10(b), in that Section 14(e) applies only to acts and practices in connection with tender offers. Section 10(b) prohibits fraud "in connection with the purchase or sale of any security."

for Small Businessmen: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. 10 (1970) (testimony of SEC Chairman Budge) (*Additional Consumer Protection*). Section 15(c)(2)(D) authorizes the SEC to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative" by broker-dealers in the over-the-counter market—the same broad language as is found in Section 14(e).[22]

Congress enacted Section 15(c)(2) in 1936 because it believed that the SEC's rulemaking authority under Section 10(b), part of the original 1934 Act, was inadequate to deal with the problem of broker-dealer overreaching. Section 15(c)(2) authorized the SEC to "define" fraud with respect to broker-dealers in the over-the-counter market, and thereby subjected broker-dealers to more than "the general concepts of fraud which are already in the statute." *Unlisted Securities: Hearing on S. 4023 Before the House Comm. on Interstate and Foreign Commerce*, 74th Cong., 2d Sess. 14 (1936) (testimony of SEC Chairman Landis); see also H.R. Rep. No. 2307, 75th Cong., 3d Sess. 11 (1938). When Congress added the same language to Section 14(e),

[22] When Congress enacted Section 14(e)'s rulemaking provision in 1970, the Commission had already used its rulemaking authority under Section 15(c)(2) to define as "fraudulent, deceptive, or manipulative act[s] or practice[s]" a number of practices that had not constituted common law fraud. See 17 C.F.R. 240.15c2-1 (1970) (proscribing the hypothecation of customer securities by a broker-dealer where hypothecated securities would be commingled); 17 C.F.R. 240.15c2-3 (1970) (proscribing transactions by broker-dealers in unvalidated German securities); 17 C.F.R. 240.15c2-4 (1970) (requiring the prompt transmittal of funds received by broker-dealers in connection with the distribution of securities); 17 C.F.R. 240.15c2-5 (1970) (requiring written disclosure of credit terms and commissions and customer suitability determination in connection with the sale of securities on margin by broker-dealers).

it similarly gave the SEC "full rulemaking powers," which it considered an "utmost necessity," to prevent overreaching in the tender offer context. See 116 Cong. Rec. 3024 (1970) (remarks of Sen. Williams). The history of Section 14(e)'s grant of rulemaking authority thus establishes that it authorizes the SEC to go beyond the limitations of the pre-existing prohibitions against fraud.

2. Rule 14e-3(a) is also supported by the Commission's power under Section 14(e) to "prescribe means reasonably designed to prevent" fraud. That authority "necessarily encompasses the power to proscribe conduct outside the purview of fraud, be it common law or SEC-defined fraud." *Chestman*, 947 F.2d at 558 (opinion of Meskill, J.); *Maio*, 51 F.3d at 635 ("The power to define and prescribe means 'reasonably designed to prevent' fraudulent, deceptive, or manipulative acts and practices must extend further than the mere proscription of acts and practices that are in fact fraudulent, deception, or manipulative; otherwise this language is superfluous."). This Court recognized in *Schreiber* that Section 14(e) gives the Commission "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts." 472 U.S. at 11 n.11. The court of appeals stated, however, that, "[p]roperly read, this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule." Pet. App. 35a. That statement overlooks the fact that the SEC's rulemaking power to adopt "means reasonably designed to prevent" fraud necessarily authorizes prophylactic requirements that may sweep more broadly than the underlying prohibitions in order to ensure that the forbidden "deceptive acts" do not occur.

B. Rule 14e-3(a) Is A Valid Exercise Of The SEC's Rulemaking Authority

Rule 14e-3(a) is a valid exercise of the SEC's authority to "define * * * such acts and practices as are fraudulent, deceptive, or manipulative" in the tender offer context, and to "prescribe means reasonably designed to prevent" fraud. The Rule is a reasonable, and indeed necessary, means of accomplishing Congress's objectives in the Williams Act. It therefore satisfies the deferential standard of review applicable to legislative rules. See *Chevron*, *supra*; *Batterton*, *supra*.

Congress enacted the Williams Act to ensure "full disclosure" of information to investors in the tender offer context. See *Schreiber*, 472 U.S. at 8-11; 113 Cong. Rec. 24,664 (1967) (remarks of Sen. Williams); H.R. Rep. No. 1711, 90th Cong., 2d Sess. 11 (1968); S. Rep. No. 550, 90th Cong., 1st Sess. 11 (1967). The Williams Act accordingly requires that persons "engaged in making or opposing tender offers *or otherwise seeking to influence the decision of investors* or the outcome of the tender offer" must make full disclosure of material information in their possession before trading (or abstain from trading). *Schreiber*, 472 U.S. at 11 (quoting H.R. Rep. No. 1711, *supra*, at 11) (emphasis added).

Rule 14e-3(a) is aimed directly at those who would unfairly "influence the decision of investors" by trading on the basis of material, nonpublic information about a tender offer derived from inside sources. Trading on inside information about a tender offer frustrates Congress's intent to preserve a "neutral setting," such that investors can fully evaluate the benefits and disadvantages of the offer. *Schreiber*, 472 U.S. at 9; see 45 Fed. Reg. 60,412 (1980). Accordingly, Rule 14e-3(a) sets forth a "disclose or abstain" rule: "In order to avoid the prohi-

bition on trading, there must be public disclosure within a reasonable time prior to any such purchase or sale. This public disclosure may be made by the person who has acquired information subject to the prohibition or by another person." *Id.* at 60,413.[23]

The "full disclosure" for investors and the "neutral setting" intended by the Williams Act implicate situations well beyond those in which a trader has misappropriated information about a tender offer in violation of a fiduciary duty. As the SEC noted in an extensive 1971 study of the role of institutional investors in the securities markets, bidding companies may pass information about planned tender offers to favored investors, in the hope that those investors would purchase large blocks of stock and ally themselves with the bidder in the contest for corporate control (or in subsequent issues of corporate management).[24] Those investors, armed with critical information about a planned takeover bid, would have an unfair advantage over others in the market, even if their use of that information to purchase stock in the target company were not a breach of a fiduciary duty to the *source* of the information (and, indeed, had been encouraged by the

[23] Disclosure of the inside information before trading, therefore, obviates the trader's liability under Rule 14e-3(a). 45 Fed. Reg. 60,414 (1980). Disclosure does not, however, eliminate the trader's liability under state law for misappropriating the inside information. *Id.* at 60,413. In practical effect, therefore, abstention from trading may be the only lawful alternative to persons in possession of material, nonpublic information about tender offers. *Ibid.* But Rule 14e-3(a) itself imposes an obligation to disclose or abstain, not a flat obligation to abstain, and there may be situations in which a trader is free to disclose the information without liability to the source.

[24] See *Institutional Investor Study Report of the Securities and Exchange Commission*, H.R. Doc. No. 64, 92d Cong., 1st Sess. Pt. 1, at xxxi-xxxiii (1971); *id.* Pt. 8, at 125-127; see also 45 Fed. Reg. 60,412 (1980).

source). As the Court noted in *Chiarella*, such tipping and use of information to purchase shares in target companies, known as "warehousing," was prohibited by the SEC because "the seller's behavior presumably would be altered if he had the nonpublic information." 445 U.S. at 234.

Congress was aware of the unfairness of such insider trading when in 1970 it authorized the SEC to promulgate rules to define and prevent fraud in connection with tender offers. When Senator Williams asked the SEC for examples of deleterious practices that the proposed rulemaking authority would be used to prevent, the SEC described a situation in which a "person who has become aware that a tender bid is to be made, or has reason to believe that such bid will be made, may fail to disclose material facts with respect thereto to persons who sell to him securities for which the tender bid is to be made." *Additional Consumer Protection* 12. "Notably, this hypothetical does not contain any requirement that the trader breach a fiduciary duty." *Chestman*, 947 F.2d at 559 (opinion of Meskill, J.). Accordingly, there is every reason to believe that Congress intended to authorize the SEC to prohibit the misuse of inside information with respect to tender offers by persons other than fiduciaries.

Rule 14e-3(a) is also "reasonably designed to prevent" instances of fraud in tender offers. Material, nonpublic information relating to a tender offer necessarily is circulated to many people, such as attorneys, investment bankers, and accountants, involved in structuring the transaction. The availability of that information may lead to abuse because "even a hint of an upcoming tender offer may send the price of the target company's stock soaring." *SEC* v. *Materia*, 745 F.2d 197, 199 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985). Trading on such information most likely will involve a breach of a duty of confidentiality to the bidder or target company, or to persons repre-

senting either party. But it may be "almost impossible to prove that the trader obtained such information in breach of a fiduciary duty owed either by the trader or by the ultimate insider source of the information." *SEC* v. *Peters*, 978 F.2d 1162, 1167 (10th Cir. 1992). The difficulties of establishing such a breach may permit sophisticated insider trading to go unpunished. Rule 14e-3(a) avoids those problems by prohibiting a class of securities transactions in which the likelihood that such a breach of duty has occurred is great, without requiring specific proof of a breach of fiduciary duty. The Rule is therefore a "means reasonably designed to prevent" fraudulent trading on material, nonpublic information in the tender offer context.

C. Congressional Action Has Validated Rule 14e-3(a)

As with the misappropriation doctrine under Section 10(b), action by Congress since the promulgation of Rule 14e-3(a) has confirmed the Rule's validity. In 1983, a committee report on a bill to strengthen sanctions against insider trading (which was eventually enacted) specifically noted Rule 14e-3 and proposed no changes to it.[35] In 1988, Congress passed ITSFEA and, in it, expressly ratified the SEC's "rules * * * governing trading while in possession of material, nonpublic information." See pp. 32-35, *supra*. Congress was, of course, well aware that Rule 14e-3 was such a rule. See H.R. Rep. No. 910, *supra*, at 14 (discussing role of Rule 14e-3 in combatting insider trading, by inducing firms to establish supervisory systems to detect such trading and control the flow of sensitive information that might be misused). Accordingly, Rule

[35] See H.R. Rep. No. 355, *supra*, at 4. The bill discussed in the Report became the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264.

14e-3 was brought to the attention of Congress and validated by that body. That action confirms that the Rule is consistent with the SEC's authority under Section 14(e).

III. RESPONDENT'S MISAPPROPRIATION OF CONFIDENTIAL INFORMATION TO TRADE IN SECURITIES VIOLATED THE MAIL FRAUD STATUTE

1. The mail fraud statute, 18 U.S.C. 1341, prohibits the use of the mails "for the purpose" of furthering "any scheme or artifice to defraud." In *Carpenter* v. *United States*, 484 U.S. 19 (1987), this Court held that a reporter's scheme to misappropriate his employer's confidential business information for securities trading constituted a "scheme or artifice to defraud" in violation of the mail fraud statute. The Court concluded that, because the reporter had obtained the confidential business information in the course of his employment, his unauthorized use of that information for personal gain amounted to fraudulent activity proscribed by the mail fraud statute. *Id.* at 27-28 (citing *Snepp* v. *United States*, 444 U.S. 507, 515 n.11 (1980) (per curiam)). The Court explained that "a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom." *Ibid.*

Respondent's misappropriation of the confidential information that a Dorsey client planned to make a tender offer for Pillsbury stock was no less fraudulent than the reporter's misappropriation of the confidential business information in *Carpenter*. Because respondent obtained that information in the course of his employment with Dorsey, he was bound not to use it in a manner not

authorized by his law firm. As a Dorsey partner, he was also bound not to use the confidential information about the takeover in a manner not authorized by the client. Respondent nevertheless deceived his firm and its client by posing as a faithful attorney working for his firm's and client's interests. Respondent's use of the information to trade in Pillsbury securities for his personal gain deprived Dorsey and Grand Met of the right to use the confidential information exclusively for the purpose for which the information had been entrusted to the law firm, and therefore amounted to fraud on the firm and the client.

2. The court of appeals' reversal of respondent's mail fraud convictions cannot be reconciled with this Court's decision in *Carpenter*. The court of appeals concluded that the mail fraud convictions could not stand because "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." Pet. App. 37a. The court of appeals reasoned that, because respondent's "conduct did not constitute securities fraud, * * * there was no fraud upon which to base the mail fraud charges." *Ibid.*

Carpenter establishes, however, that a person who misappropriates confidential business information in breach of a fiduciary duty and then trades on it in the securities markets has engaged in a scheme to defraud within the mail fraud statute, whether or not the identical conduct violates the securities laws. In *Carpenter*, the Court noted that the same "appropriation of confidential information [owned by the *Journal*] * * * underlay both the securities laws and mail and wire fraud counts." 484 U.S. at 24. And although the Court was evenly divided with respect to the convictions under the securities laws in *Carpenter*, it unanimously affirmed the mail and wire fraud convictions. *Ibid.* Thus, *Carpenter* makes clear

that mail fraud charges are independent of securities fraud charges, even when both rest on the same set of facts.

Although the conduct that constituted the charged scheme to defraud—namely, respondent's misappropriation of confidential information about Grand Met's plan to make a tender offer for Pillsbury stock—was essentially the same for purposes of both the securities and mail fraud counts in this case, the indictment did not make the mail fraud counts dependent on the securities fraud counts. The mail fraud counts did not charge, as an element of the offense, that respondent had committed mail fraud by using the mails to commit violations of the securities laws. Rather, the indictment set forth the acts that were alleged to form the scheme to defraud, and then charged, in separate counts, first, that those acts violated the mail fraud statute, and second, that the acts violated the securities fraud statutes. See J.A. 8-23.[26] Further, the district court instructed the jury on the mail fraud counts separately from the securities fraud counts, and gave the jury no indication that proof of a mail fraud violation was dependent on proof of a securities law violation. See J.A. 192-194. Indeed, the court concluded the mail fraud instructions before even describing the elements of the violations under the securities laws. J.A. 194. Accordingly, respondent's conviction on the mail fraud count was in no way dependent on a finding that he violated the securities laws.

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[26] The indictment in *Carpenter* was drawn in the same way. See 86-422 J.A. 1-13 (setting forth the means and objects of the conspiracy), 15 (¶ 39) (charging those means and objects as part of the scheme in violation of Rule 10b-5), 17 (¶ 42) (charging those means and objects as part of the scheme in violation of the wire fraud statute), 20 (¶ 45) (charging those means and objects as part of the scheme in violation of the mail fraud statute).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX

1. Section 1341 of Title 18, United States Code, provides:

§ 1341. Frauds and swindles

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail or such carrier according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined under this title or imprisoned not more than five years, or both. If the violation affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

2. Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. 78j, provides, in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

3. Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(e), provides:

(e) Untrue statement of material fact or omission of fact with respect to tender offer

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The [Securities and Exchange] Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to

prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

4. Section 20A(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78t-1(a), provides:

(a) Private rights of action based on contemporaneous trading

Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

5. Section 2 of the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, 15 U.S.C. 78u-1 note, provides:

The Congress finds that —

(1) the rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.] governing trading while in possession of material, nonpublic information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors;

(2) the Commission has, within the limits of accepted administrative and judicial construction of such rules and regulations, enforced such rules and regulations vigorously, effectively, and fairly; and

(3) nonetheless, additional methods are appropriate to deter and prosecute violations of such rules and regulations.

6. Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

7. Rule 14e-3(a) of the Securities and Exchange Commission, 17 C.F.R. 240.14e-3(a), provides:

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive, or manipulative act or practice within the meaning of section 14(e) of the [Securities Exchange] Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is

nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

(1) The offering person,

(2) The issuer of the securities sought or to be sought by such tender offer, or

(3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.